Memery Bank

State Participation in Oil and Gas Projects

A Case Study of Participation by the Province of Newfoundland and Labrador

Sean Rush discusses State Participation in its various forms, with particular emphasis on the petroleum industry, and considers the Energy Plan of Newfoundland and Labrador, Canada as a case study.

INTRODUCTION

Equity participation by State owned organisations ('State Participation') is a common feature of the upstream petroleum industry. The ownership interest share that comes with State Participation provides a right to jointly manage and direct the enterprise and to receive a financial benefit generated by the project. However, it has been observed that as regards a business enterprise within its jurisdiction, a State already has the sovereign authority to direct its affairs as it sees fit and, by taxation, to receive a financial benefit. As such, the question arises as to what else if anything is to be gained by State Participation?

This paper introduces State Participation in its various forms with particular emphasis on the petroleum industry. It considers the Energy Plan of Newfoundland and Labrador, Canada (the 'Province') as a case study in State Participation. It analyses the Province's motivations to participate, the implementation of its Energy Plan with respect to three offshore projects and the associated risks that have accrued as a result. It concludes by questioning whether State Participation is the most appropriate mechanism to achieve the Province's objectives and whether other fiscal tools may achieve the same goals for less risk.

STATE PARTICIPATION

State Participation denotes the structure whereby a State owned entity will take an equity participating interest in a project as consortium member. As seen in figure 1 on the following page, State Participation is a common feature of the international upstream industry:

Generally, State Participation can be divided into three different forms:

Working Interest
Where a State takes a working interest in a project it is effectively acting as an international oil company ('IOC'). After making a cash payment for its share, it will be responsible for its share of cash calls and other invoices of capital or operating expenditure. It will be entitled to a share of petroleum once production has commenced but also ongoing liabilities, such as those relating to oil spills and abandonment. Accordingly, the State may have a similar risk/reward balance as the IOCs depending on when it joins the consortium and for what value.

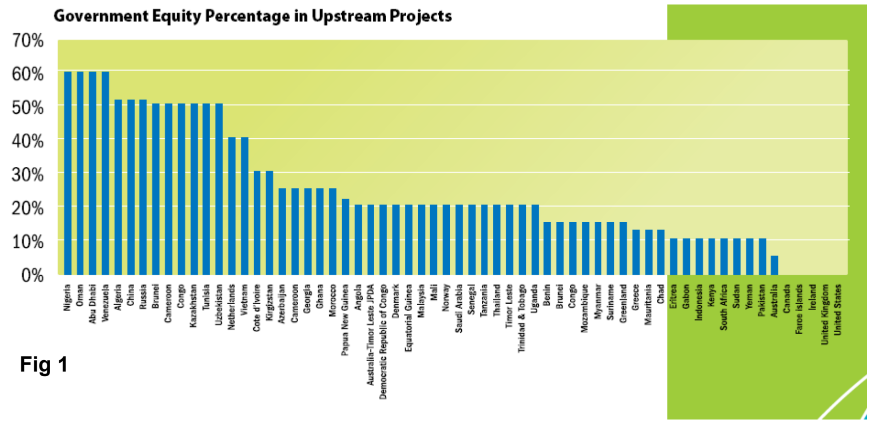


Fig 1

Carried Interest
The carried interest mechanism requires the IOCs to carry the State participant's costs through the exploration and development stages. Unlike the working interest structure where a cash payment is made in return for the State's entry into the project, carried costs are recovered by the IOCs from a proportion of the State's share of production revenues. Once the outlay has been recovered then the State will take its full share of profit going forward.

Free Equity
Free Equity denotes the mechanism where the state takes a share in the project for no consideration and takes a defined share of the profits. Whilst this may appear unduly generous from the IOCs', because they are outlaying the full capital sum, they will typically obtain a lower tax liability to ensure their requisite rates of return are maintained.

According to Padmore, the 'true and valid' reasons to participate are: (i) to replace a withdrawing IOC; (ii) at the IOC's invitation to reduce sovereign risk or (iii) to reduce feelings of suspicion or hostility in the minds of the local population. Political or nationalistic reasons are not considered valid. Andrews cautions that: 'Considerations of sovereignty, prestige and politics should not overrule financial risk analysis'.

The strategic motives for State Participation will be examined in the case study to assess whether such considerations have overruled the financial risk analysis.

CASE STUDY: THE ENERGY PLAN OF NEWFOUNDLAND AND LABRADOR

Background to the Energy Plan

To understand the political culture and local sentiment in which the Energy Plan was developed it is helpful to understand the perceived injustices delivered to the Province historically with respect to its natural resources.

The 1969 Churchill Falls power contract between Hydro-Québec and the Churchill Falls (Labrador) Corporation has been a matter of considerable resentment. The contract concerns the development and subsequent sale of electricity from the Churchill Falls hydro site, one of the world's largest, to Hydro-Québec on a long-term basis at an extremely low price. The forty four-year term of the contract runs from 1972 to 2016. However, the contract provides for automatic renewal at the expiry date for a further period until 2041 with the terms predetermined to deliver electricity on a near free basis.

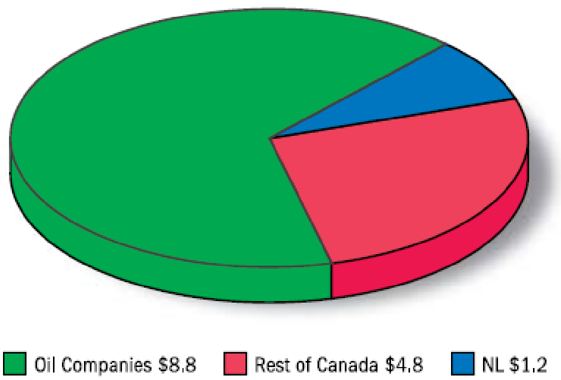
It has been estimated that the value of the Churchill Falls power contract to Quebec has been $19 billon with the Province netting a mere $1billion. Another $50 billion has been estimated to accrue to Quebec from the remaining term of the contract. Understandably it is viewed locally as a complete value transfer to Quebec of the Province's hydro resource.

Similarly, the share of revenue from the Hibernia field is a sensitive issue. Despite preferring the experienced Norwegian fabrication yards, the IOCs agreed to build the gravity based structure ('GBS') locally, providing 8 million man hours of employment. The risk profile of the project at time of sanction suggested it was marginal. The Project stalled when Gulf Oil withdrew and the Federal Government had to step in to save the project. Recognising the benefits from local construction of the GBS a royalty package was agreed that provided a minimal return to the Province. The unexpected additional reserves found at Hibernia has provided a windfall to all stakeholders and the IOCs in particular but the royalty regime was not sufficiently flexible to redistribute more profit to the Province. Accordingly, the Hibernia revenues (see figure 2 below) when viewed in isolation fuel a public perception within the Province that the Hibernia field has benefited the IOCs and the rest of Canada at the expense of the Province (NL).

Hibernia Project Net Revenue
Summary to Dec 2006 (Billions $CDN – Nominal)

Fig 2

Total Net Revenue $14.8 Billion



Legislative Background

In an effort to take control of its resources, the Province brokered the Atlantic Accord with the Federal Government in 1985. The Atlantic Accord was ratified by statute as the Atlantic Accord Act and is the primary legislation governing oil and gas activities in offshore East Coast Canada. The

Act settled the administration of the East Coast extra – territorial waters as being the joint responsibility of the Province and the Federal Government but empowered the Province to establish and collect resource revenues as the State.

The Energy Plan

The Energy Plan was issued in 2007 and is a comprehensive, long – term, strategic policy document created with the predominant purpose of providing strategic direction for the development of the Province's wealth of hydro electricity, oil and gas, wind and other natural resources. It was developed after a wide public consultation process including the receipt of written submissions and public consultations at 11 locations around the Province.

The Energy Plan states that it has been developed 'clearly with an eye on 2041', when the Churchill Falls electricity contract expires and the Province is in a position to negotiate a market price for the production and delivery of electricity.

The Energy Plan contains 3 principles of general application to its energy industries: (i) Sustainability; (ii) Control and Cooperation; and (iii) Coordination. The second principle, 'Control and Cooperation' is expanded as follows:

> *'We will exercise appropriate control over the development of our resources to ensure they are managed and used in the best interest of the people of Newfoundland and Labrador. We will assume an ownership interest in the development of our energy resources where it fits our strategic long - term objectives.'*

No guidance is given as to how an ownership interest may fit with achieving strategic long – term objectives.

The Province's Reasons to Participate

The Energy Plan suggests that, in the context of oil and gas, the benefits accruing to the Province from State Participation will be:

- access to additional revenue;
- knowledge to ensure alignment with industry which will allow the long term strategic development of long ignored oil and gas reserves that might not otherwise be developed; and
- potential participation in infrastructure projects, and that such benefits will facilitate its goal: 'Maximising Long – Term Value of Oil and Gas'.

The structure of participation is as a 10% working interest owner in future projects requiring development plan approval. The purchase price is to be based on historic costs with the Province picking up its share of subsequent capital and operating costs.

IMPLEMENTATION OF THE ENERGY PLAN AND AFFECTED PROJECTS

At the time the Energy Plan was announced there were well developed plans for three offshore projects: Hebron, the Hibernia South Extension ('HSE'); and the White Rose Extension ('WRE') (also known as White Rose 'growth'). Fast facts for each are listed in the table below.

Fast Facts	Hebron	WRE	HSE
Province Equity	**4.9%**	**5%**	**10%**
Purchase Price	**$110 million**	**$44 million (revision after appraisal)**[1]	**$30 million.**
Capital Spend	**$4 – 6 billion**	**$3.5 billion**[2]	**$1.5 – $2 billion**[3]
First Oil	**2016 - 2018**	**Q4 2009 / Q1 2010**	**Q3 2012**
Total Reserve	**581 million bbls recoverable oil**	**200 million bbls recoverable**	**223 million bbls recoverable oil**
Design Concept	**Stand alone GBS**	**Sub – sea tie back**	**Sub–sea tie back**

After a long and bitter process, an equity position of 4.9% was agreed with the Province for Hebron. A review of press reports and comments from readers make it clear that the Premier's popularity increased as a result of taking on 'big oil'. After Hebron, the WRE owners capitulated and awarded the Province a 5% position. The HSE project is the first project to be entirely negotiated after the Energy Plan's release and the Province duly took a 10% equity position. The purchase price for each was assessed on the basis of historic costs.

RISKS TO THE PROVINCE FROM STATE PARTICIPATION

Taking the mean case from the Fast Facts, the Province has agreed to fund approximately $700 million as its share of development costs in the projects. In return the Province anticipates receiving revenue from production commencing in 2010 (WRE), 2012 (HSE) and 2016 – 2018 (Hebron).

Capital Constraints

Unlike IOCs whose one objective is to maximise returns for its shareholders, the State is mandated to invest in areas such as health, education and security. Whilst it is comparatively simple to obtain financing for an offshore oil and gas project, capital funding for a school or hospital, for example, is scarce. Even a State will have limited access to capital financing and needs to direct its resources to investing in its people first as a prerequisite for growth, development and future prosperity. Whilst carried or free equity may ameliorate the up - front funding issue, loan financing, ongoing guarantees and abandonment obligations will continue to have a negative effect on a State's borrowing power.

The Province has transferred a large amount of immediate cash for the purchase prices and committed more for capital outlay over the short to medium term. Revenues from these investments are due to commence in 2010 but will not peak until Hebron comes on stream (optimistically) between 2016 and 2018 and will not reach peak production rates until 2 years after first oil. The liability undertaken will have the effect of reducing the Province's credit reserves and future abandonment liability could significantly offset the benefits anticipated when the Churchill Falls contract expires in 2041. Supporting Padmore's caution noted above one 'Newfie' put it succinctly when the Hebron deal was announced:

> *'I wonder if we can get some doctors or nurses now?'*

A fair question given the Province's budgeted net debt for 2009 – 10 is stated at close to $8 billion and whose per capita net debt has been estimated at $32,393.

Future Investment

Whilst State Participation can have a negative effect on the valuation of a project, it is worth reviewing the impact on investment arising from the Province's desire for equity.

It has been observed that in the period leading up to the release of the Energy Plan, interest in new exploration licences in the Province dropped from a total of $672 million bid in 2003 through to $39 million in 2006 and no interest at all in bidding land parcels in the highly prospective Jeanne d'Arc Basin or Orphan Basins in 2007, the year the Energy Plan was released.

In 2006 the Hebron project was shelved indefinitely by the IOCs as they grappled with the Province's pre – Energy Plan demand for equity. The IOCs finally capitulated as oil prices rose to record levels and it became clear that the Province would require 10% if the negotiations were not concluded prior to the Energy Plan's release. The WRE owners observed what had happened on Hebron and likewise moved quickly to embrace the Province's equity participation at 5% before the release of the Energy Plan.

On the Hibernia field, the Province's approval of a relatively simple drilling extension into the existing reservoir was withheld due to a lack of 'adequate information' despite being approved by the CNLOPB. However, the approval was provided upon the conclusion of an MOU that included terms relating to the Province's 10% working interest in the new HSE unitised formation.

The issue of future investment was highlighted by Charles Cirtwill, acting president of the Atlantic Institute for Market Studies, who stated that:

> *'Newfoundland has done significant damage to itself with international investors.'*

Human Capital and Administrative Costs

The administrative cost of funding a State owned oil company needs to be carefully understood. Whilst a Government's revenue authorities will have the requisite bureaucracy to monitor, investigate and audit tax payers, including IOCs, an oil company needs to be supported by costly professionals with expensive equipment that could equally be applied to public services. Upon incorporation in 2008, Nalcor capitalised $2.4 million of historic costs including legal fees, environmental consulting and project management costs. In its 2008 – 09 Annual Report, Nalcor reported that operational and administrative costs were $147.2 million, an increase of $4.1 million largely due to salaries. Whilst the total cost cannot be attributable solely to Nalcor's oil and gas activities, as the projects in which it participates mature it is likely that Nalcor will need to continue increasing its staffing and other overhead costs to protect is minority interests and pursue new opportunities.

In a Province with a labour force of little more than 210,000 and total population of 510,272, human capital is a scarce commodity. As with capital financing, human capital will be available to IOCs in the form of expatriate workers, but in an area with a comparatively small population and remote location, the Province needs to be cautious that it utilises its highly skilled residents to manage more traditional State responsibilities.

Project Risk

As with the other project participants, a State participant, such as Nalcor, must take its share of the risk that the project fails or is less successful than originally modelled. Although we have seen that the Province takes little historic risk, failure going forward could arise due to a range of events. For example with respect to Hebron: (i) the returns are based on a US$87 bbl WTI forward price which may prove to be optimistic; (ii) the official capital cost range of between $4 - $6 billion has been stated as having an upper range of $11 billion in a cost escalating environment (iii) Canadian – US dollar exchange rates have been extremely volatile in the intervening period and pose a significant risk given that revenues are received in US dollars but spent in Canadian dollars; (iv) the early date for first oil was estimated at 2016 however the latest estimate now states 2017 and if the GBS suffers similar delays as Hibernia did then that date is likely to be extended.

Whilst an IOC's business is to accept and manage these volatile risks, it is questionable whether a taxpayer's dollar should be risked in this manner. Whilst Nalcor has recognised some of these risks and has taken steps to mitigate them using standard industry techniques the cost of doing so is likely to be a net value loss to the Province.

AVAILABLE ALTERNATIVES

The Province's stated objective is to 'Maximise the Long - Term Value of Oil and Gas'. It believes that equity participation will facilitate this objective. However, the effects on Government take using various fiscal alternatives including royalty, corporate tax, RRT, and equity have been calculated using computer modelling. The results showed that across a range of fiscal regimes, moving a State's participation level from zero through to 51% increased the Government take from 10% through to 18% depending on the commodity price. Arguably, this is a low incremental take for such a high increase in risk. It was concluded that:

> *'The main merit of Government equity participation would appear to be to obtain effective control rather than maximise revenue.'*

Looking at each of the Province's stated benefits arising from State Participation, it appears that other alternative mechanisms with less risk could be applied.

Access to Additional Revenue

The Accord Act does not empower the Province to adjust corporate tax. As such it would appear that the simplest method of increasing revenues would be to adjust the fiscal take by increasing royalty rates. Such adjustments carry with it no incremental risks and revenue can be collected using existing resources and systems. Indeed part of the fiscal package agreed when the equity participation arrangements were finalised included an uplift to the royalty rates. Accordingly, the Province did not need to utilise State Participation as an additional method of increasing the Government take. Indeed, for the same reasons Sims observes in relation to free equity, it has been commented that the IOCs obtained a more generous fiscal package in return for the discounted purchase price.

Knowledge to Allow the Development of Long Ignored Oil and Gas Reserves that Might Not Otherwise be Developed

Facilitating the development of otherwise uneconomic reserves can be undertaken by use of alternative fiscal mechanisms. For example, in the UK when the economics of developing smaller fields became an obstacle, the Government acted to abolish petroleum revenue tax ('PRT') for all new fields receiving development consent after March 1993. Other instruments such as tax credits, tax holidays and accelerated depreciation will also act to encourage the development of marginal reserves.

Knowledge itself and skills transfer are a common requirement of many regimes including that of the Province. Along with the equity and fiscal arrangements, the IOCs are required to commit to a Benefits Agreement that provides for the use of local content and a commitment to local research and development. Certainly the Benefits Agreement could be expanded to include knowledge transfer in other areas that the Province considers important.

Participation in Infrastructure Projects

It seems circular to justify State Participation by referencing a desire to participate in projects. For the reasons outlined above, there are numerous tools available to ensure a State is able to achieve its objectives without taking equity.

In terms of oil and gas infrastructure, the Province sees the potential for 'gas to wire' electricity, associated pipelines and processing plants and anticipates the investment in an LNG transhipment terminal and new oil refinery at Placentia Bay. When such developments are sanctioned, the Province will be called upon to facilitate the numerous consents that will be necessary, coordinate the project planning to ensure that existing infrastructure and labour force are managed effectively whilst maintaining a stable and predictable fiscal environment that would make such a project attractive to financiers. Taking equity in such projects is likely to confuse the Province's priorities and could potentially create a barrier to investment.

CONCLUSION

It may be unfair to judge the risks undertaken by Nalcor Energy by reference to one business unit in isolation. When the Churchill Falls contract expires in 2041, and more lucrative terms are negotiated, the Province will need strong management structures in place and a skilled labour force in order that reinvestment for sustainable development can be undertaken.

Nevertheless, it will be noted that in the context of oil and gas, none of the Province's reasons match with Padmore's 'true and valid' reasons for participation. Premier Williams has enjoyed significant political popularity by taking on 'big oil' at a time of high oil prices when resource nationalism was a popular global trend and, for the reasons given by Andrews, the IOCs may be sceptical of the motives behind the Province's move to State Participation.

Whilst State Participation may be valid in the context of other areas of the Province's energy industry, the broad scope of the Energy Plan has provided a platform in which to participate in all parts of the energy industry, including oil and gas. However, considering the comparatively risk free mechanisms available to the Province to achieve its objectives, the benefits that arise from State Participation in oil and gas do not warrant exposing the taxpayers to the associated risks.

About the Author

***Sean Rush** is a partner at Memery Crystal and an international energy lawyer with particular expertise in the oil and gas industry. In the 10 years prior to joining Memery Crystal, Sean held the position of Legal Manager for Petro-Canada's North West European business unit, advising the Management Team on strategic direction and overseeing the legal function for a US$7 billion business in the UK, Dutch and Norwegian sectors of the North Sea along with development opportunities in Russia.*

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